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The Manufacturers Hanover
Economic Report

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Business Conditions Update

The economic and financial outlook for 1986 remains bright. Notwithstanding continued pessimism in some quarters, it still appears as though the gross national product adjusted for inflation will rise by a faster clip this year compared with 1985. Both inflation and interest rates will remain moderate while the unemployment rate should trend lower.

A look beneath the surface indicates that this is even better news than it seems. For one thing, the expansion will be better balanced than it was last year. The goods-producing sector should make more of a contribution to economic growth this year than last, when services provided most of the thrust. For another, we are now in the 39th month of the current business expansion, and typical postwar peacetime expansions have lasted only 34 months. Indeed, once we enter the 40th month in March, the ongoing expansion will become the second-longest post-World War II peacetime expansion. Only the 58-month expansion of March 1975 to January 1980 was longer. Not a bad performance for an upswing that has been termed weaker than normal and which some economists even wrote off completely a year ago.

The Signs Are Positive...

The momentum that the economy developed toward yearend 1985 will help it throughout 1986. Not only is the jumping-off point higher than the average of last year's fourth quarter thereby ensuring a good growth rate in the current quarter, but the momentum seems strong enough to carry growth throughout the year—and at an increasing pace. Lest you think that these statements are bold with no backup, let me cite a number of facts upon which our forecast is based:

- The foreign exchange value of the dollar has fallen by about 27 percent in the past year;
- Growth in the money supply in 1985 was the fastest for any year in postwar history;
- The rate of business inventory building slowed at the sharpest pace for any 12-month period since the end of the second World War;
- Employment is at a record level—both in terms of the number of people at work, as well as when compared with the over-sixteen population;
- The stock market has jumped more than 30 percent in the past five months, setting new records in the process;
- Oil prices in spot markets have fallen by as much as 50 percent since last autumn.

Now what I would like to do is draw some implications from each of these facts that bear on the business outlook. The 27 percent drop in the value of the dollar compared with the currencies of our major trading partners bodes well for domestic producers of goods. It is true that there is a lag between when the dollar peaks and when the trade deficit begins to fall (Economic Report—January 1986). However, one year has now gone by since the dollar peaked, which is on the long end of previous lags. Furthermore, evidence from the "real" economy seems to suggest that an adjustment is already being made. Employment in manufacturing industries has been climbing for four consecutive months, reversing some 60 percent of the decline in factory jobs that occurred between January and September 1985. Manufacturing output is up by 1½ percent since October after changing very little in the previous 12 months.

The implications of rapid money growth are less ambiguous and faster-acting. First of all, there is plenty of money available for spending. In addition, funds can be borrowed at interest rates well below those of a year ago. For example, the rates that banks charge their biggest and best customers for short term loans are approximately one percentage point lower today than they were last year at this time. Those corporations that are big enough and have a high enough credit rating to access the money markets directly are also finding interest rates about one percentage point below last year. And this is for short-term borrowing; funds raised in the bond markets cost business nearly three percentage points less today that they did in early 1985.

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Credit the Federal Reserve for these developments. Ignoring its rigid money supply targets, the Fed has been extremely accommodative over the past several years, making sure that the supply of money and credit available in the economy has exceeded the demand so that interest rates might fall. There is every reason to think that the Fed will continue this posture. For one thing, although economic growth is picking up this year compared with last, it is far from a pace that would be considered so rapid as to lead to an overheated economy. There still remains a large amount of excess capacity in the United States, not to mention a large number of people without work who would like to be employed. In addition, there are sizable amounts of debt on the balance sheets of consumers, corporations and countries and the ability of these entities to service these debts would not be enhanced were interest rates to rise. Finally, and notwithstanding the rapid growth in the money supply, the rate of inflation remains moderate. Whatever linkage might have existed between money growth and inflation seems to have been loosened—if not severed completely—in the wake of the strong dollar and falling commodities' prices.

...For Faster Economic Growth...

The volatility in inventory spending and its effects on output can be seen in the economic growth rates posted over the past two years. Although the inflation-adjusted GNP grew only 2.3 percent in 1985, substantially below the 6.6 percent rate of advance of 1984, when changes in business inventories are subtracted from both years, the rate of growth did not differ materially. Real final sales increased by four percent last year, compared with 4½ percent in 1984.

The diversions in output in these years stemmed primarily from different postures toward inventory accumulation adopted by business. Early in 1984, there was a feeling in the business community that inventories had gotten too low relative to current and projected sales. In addition, many businesses believed that the rate of inflation would accelerate as it typically does in the second year of a business recovery. That belief provided an incentive to stock up on goods, since inflation would be increasing the value of inventories, thus boosting profitability. Futhermore, business plans for investment in plant and equipment were also strong, sending a signal to a wide variety of industries to gear up for the expected increase in demands. As a result, inventory accumulation of almost $63 billion (real terms) took place in 1984, adding more than two percentage points to that year's real GNP growth.

Last year the situation was reversed. The continued climb in the value of the dollar diverted increasing chunks of spending from domestically-made goods to foreign merchandise. Accordingly, sales fell short of expectations and businesses throughout the entire chain of production and distribution found themselves stuck with large amounts of unsold goods. When combined with the continued low rate of inflation posted both in 1984 and in 1985, along with high real interest rates, the air was taken out of the inventory balloon. Businesses turned cautious, determined to keep their stocks as lean as possible. While this led to more efficient inventory management in 1985, it did subtract almost two percentage points from GNP growth as the $63 billion accumulation pace of 1984 melted into an increase of only $5.6 billion in 1985.

As a result of these policies, inventories in many lines of business are now at extremely low levels relative to sales. It would thus seem logical to expect no further drain in output from inventory policies. This would be the case if inventories were accumulated no faster than sales are rising. But with demand now strengthening for domestically-produced goods, it is possible that business would want to step up the pace of inventory accumulation in order to serve customers better.

The rise in employment is nothing to be trifled with. In the past three years, civilian employment has jumped by nearly ten million people or ten percent, following three years of stagnation. Not only has this brought the unemployment rate down from a postwar peak of nearly 11 percent to 6.7 percent, the lowest rate in almost six years, but it has carried employment to record highs. This alone is significant, for it has put more dollars in the hands of consumers, whose spending accounts for two out of three dollars that make up the GNP.

High employment levels not only lead to greater spending because of increased incomes, they also encourage people to loosen their wallets because of greater confidence. Another impact on wealth and confidence can be seen from the stock market. While fewer than one person in five owns stocks directly, a great number are no doubt aware of developments down on Wall Street. So besides the greater spending power that a rising stock market confers on those who own stocks, there is greater confidence that develops among the population at large just from observing the stock market rise.

February, 1986
MHT FORECAST OF GROSS NATIONAL PRODUCT
(Seasonally Adjusted Annual Rates)
In $ Billions

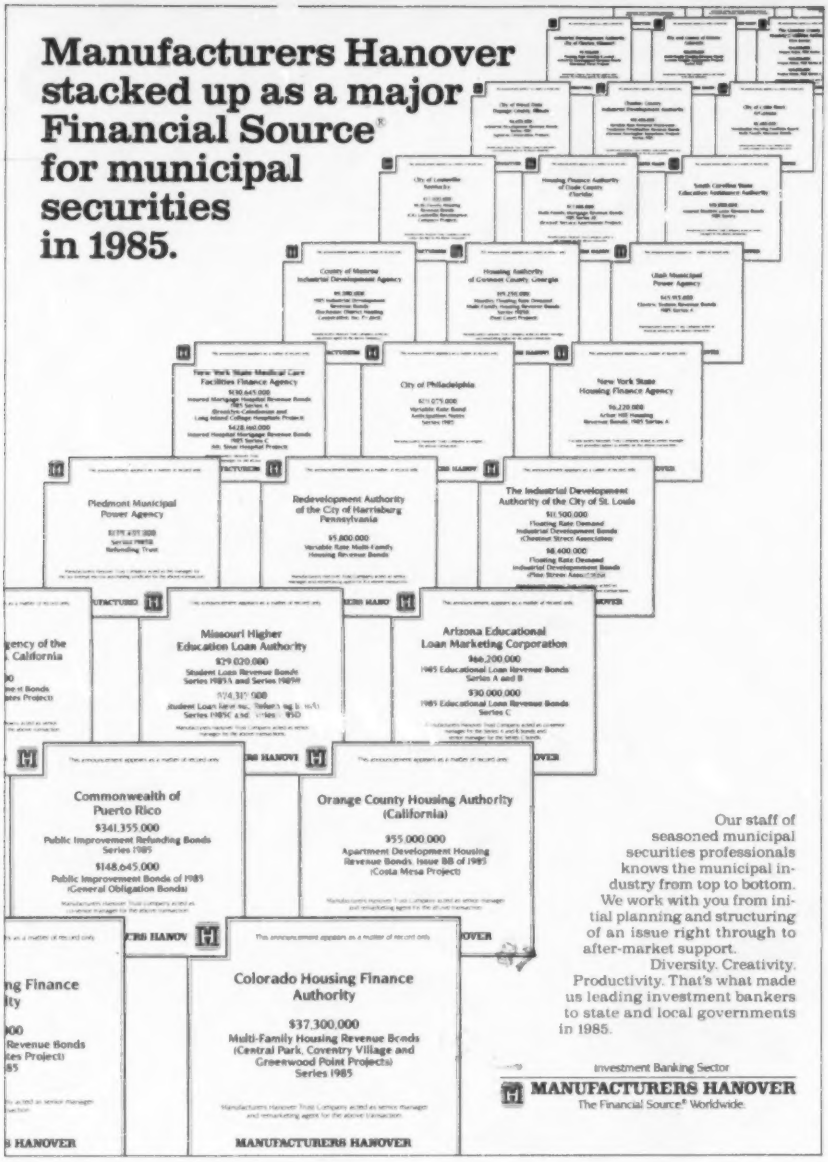
	< Actual						Projected >					
	1985				YEAR 1985		1986				YEAR 1986	
	1	2	3	4	LEVEL	% CH	1	2	3	4	LEVEL	% CH
Gross National Product	3917.5	3960.6	4016.9	4061.5	3989.1	5.7	4144.9	4204.2	4278.1	4357.7	4246.2	6.4
GNP: $82	3547.8	3557.4	3584.1	3594.8	3571.0	2.3	3632.2	3660.4	3696.9	3735.8	3681.3	3.1
% Change, Annual Rates	3.7	1.1	3.0	1.2	2.3		4.2	3.1	4.0	4.3	3.1	
Consumption	2525.0	2563.3	2606.1	2634.0	2582.1	6.6	2683.0	2716.7	2760.7	2811.8	2743.1	6.2
Durables	351.5	356.5	376.0	360.3	361.1	9.1	371.7	375.4	382.9	392.6	380.6	5.4
Non-Durables	895.7	910.2	914.5	928.6	912.3	4.6	938.4	943.3	952.5	965.1	949.8	4.1
Services	1277.8	1296.6	1315.6	1345.1	1308.8	7.3	1373.0	1397.9	1425.4	1454.1	1412.6	7.9
Investment	657.6	672.8	666.1	678.0	668.6	−0.8	716.3	745.3	762.1	781.3	751.2	12.4
Non-Residential	459.6	474.2	478.5	490.9	475.8	11.2	499.4	507.2	515.5	520.8	510.7	7.3
Producers Durable Equipment	293.5	304.5	308.1	315.7	305.5	9.0	322.3	327.6	331.6	336.4	329.5	7.9
Structures	166.1	169.7	170.4	175.2	170.3	15.4	177.1	179.5	183.9	184.5	181.3	6.5
Residential	179.4	183.1	187.4	192.6	185.6	3.6	196.3	202.6	210.5	215.1	206.1	11.0
Inventory Changes	18.5	15.5	0.2	−5.5	7.2		20.6	35.5	36.1	45.3	34.4	
Net Exports	−42.3	−70.3	−87.8	−106.9	−76.8		−97.2	−95.6	−93.8	−92.5	−94.8	
Government Purchases	777.2	794.8	832.5	856.5	815.3	10.6	842.8	837.9	849.1	857.0	846.7	3.9
Federal Defense	249.5	256.0	269.9	272.5	262.0	10.6	267.4	263.0	267.4	270.3	267.0	1.9
Federal Civilian	84.9	81.7	95.0	110.4	93.0	22.4	92.1	84.2	84.1	79.1	84.9	−8.7
State & Local	442.8	457.1	467.7	473.6	460.3	8.6	483.3	490.7	497.7	507.6	494.8	7.5
Final Sales: $82	3532.0	3542.3	3585.8	3601.5	3565.4	4.0	3613.9	3629.3	3665.2	3696.3	3651.2	2.4
% Change, Annual Rates	6.2	1.2	5.0	1.8	4.0		1.4	1.7	4.0	3.4	2.4	
Domestic Demand: $82	3619.6	3658.5	3703.9	3728.8	3677.7	2.8	3763.7	3786.3	3816.5	3848.9	3803.9	3.4
% Change, Annual Rates	0.4	4.4	5.1	2.7	2.8		3.8	2.4	3.2	3.4	3.4	
GNP Price Index (1982 = 100)	110.4	111.3	112.1	113.0	111.7	3.3	114.1	114.9	115.7	116.6	115.3	3.3
% Change, Annual Rates	3.0	3.3	2.9	3.3	3.3		4.0	2.6	3.0	3.2	3.3	
Consumer Price Index (1967 = 100)	317.8	321.1	323.0	326.3	322.1	3.5	328.7	330.8	333.7	336.7	332.5	3.2
% Change, Annual Rates	3.3	4.2	2.4	4.1	3.5		3.1	2.6	3.5	3.7	3.2	
Total Personal Income	3240.9	3280.1	3298.5	3354.1	3293.4	5.8	3415.7	3464.8	3523.5	3582.6	3496.7	6.2
Disposable Personal Income	2739.2	2817.7	2800.2	2845.6	2800.7	4.9	2898.2	2937.7	2985.0	3031.9	2963.2	5.8
Savings Rate	4.8	5.9	3.7	4.1	4.6		4.0	4.0	4.0	3.7	3.9	
Unemployment Rate	7.3	7.3	7.2	7.0	7.2		6.8	6.7	6.6	6.4	6.6	
Indus. Production (1977 = 100)	123.8	124.2	124.8	125.2	124.5	2.2	127.7	128.3	130.1	132.5	129.7	4.1
Housing Starts (000)	1795.0	1771.7	1673.0	1747.3	1734.8	−1.6	1770.9	1887.0	1952.0	1908.4	1879.6	8.3
Domestic Auto Sales (000)	8454.7	8239.0	9440.3	6996.3	8282.6	4.2	7959.9	7480.8	7752.3	7842.3	7758.8	−6.3
Corporate Pre-Tax Profits	220.0	218.7	228.6	232.7	225.0	−5.3	233.6	246.7	256.0	263.0	249.8	11.0
− Taxes	83.4	82.3	87.4	89.3	85.6		89.5	96.1	99.6	101.9	96.8	
Net Profits	136.6	136.4	141.1	143.4	139.4	−3.2	144.1	150.6	156.4	161.1	153.1	9.8
− Dividend Payments	82.0	83.1	83.9	85.0	83.5	6.9	86.2	87.5	88.8	90.1	88.1	5.5
Undistributed Profits	54.6	53.3	57.3	58.4	55.9	−15.2	58.1	62.6	67.2	69.7	64.4	15.2
+ Depreciation	325.4	334.0	346.8	357.8	341.0		362.5	367.2	371.9	375.9	369.4	
− Inventory Profits	−0.7	−2.2	−4.7	10.0	0.6		−0.7	−4.0	3.6	13.1	3.0	
Net Cash Flow	380.7	389.5	408.8	406.2	396.3	10.7	421.3	433.8	435.5	432.5	430.8	8.7

...With Low Inflation

Notwithstanding the knee-jerk reaction of some in the media and on Wall Street, the recent drop in oil prices contains far more pluses than minuses. It may be true that some oil-exporting countries will receive less revenues than they did before. But they—and the non-oil developing countries that have been so much in the news of late—will also benefit from the reduced rate of inflation, lower interest rates, and faster economic growth in the industrial countries that will also result.

Oil's influence is so ubiquitous, its lower price is bound to be a tonic for our economy. For one thing, the drop in oil prices is analogous to a tax cut. It puts more purchasing power in the hands of consumers and business—yet it does not carry with it the adverse effects of lowering government revenues, thus widening the budget deficit. Speaking of deficits, if current prices hold, our trade deficit will be reduced by some $13 billion this year, since we import around 1⅓ billion barrels of oil annually. The cost of transportation both on the ground and in the air will decline, which means less inflation and/or greater profits. Since oil is widely used to produce power, the cost of manufacturing will decline—not to mention the cost of lighting and heating. Finally, because oil is also used as a feedstock—a component in the production process of plastics, chemicals, rubber and clothing—its decline in prices has obvious benefits here as well.

Putting it all together, we come up with a fairly bright forecast for the U.S. economy and its major sectors for 1986 [see table]. Not only will growth outpace last year's rate, but it will do so in the context of little or no change in the rate of inflation and relatively stable interest rates. When it comes to economic forecasting, there can be no guarantees. Unlike the "hard" sciences such as physics, chemistry and biology, economics is a "soft" science, dealing with the behavior of people, which is constantly changing. However, the existence of these facts makes the outlook about as definite as it could be, so relax and enjoy it.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